UNITED STATES SUPREME COURT,

OCTOBER TERM, 1904.

BERTHA DOCTOR and KATHERINE SAYLES,
Appellants,

against

JOHN J. HARRINGTON, DENNIS A. HARRINGTON, SOL SAYLES COMPANY and SAYLES, ZAHN COMPANY,
Appellees.

No. 477.

Appeal from the Circuit Court of the United States for the Southern District of New York, Second Circuit.

Appellants' Argument.

This action was brought by the appellants, as stockholders of the Sol Sayles Company, a corporation organized under the laws of the State of New York, for the purpose of vacating and setting aside a judgment obtained by the appellees Harrington against the Sol Sayles Company in the Supreme Court of the State of New York, on October 28, 1902, and the levy and sale under an execution issued thereunder, and of requiring the appellees

Harrington to deliver to the Sol Sayles Company certain shares of stock in the Sayles, Zahn Company, and certain bonds, belonging to the Sol Sayles Company, which had been sold under such execution, and for other equitable relief (Record, pages 7 & 9).

In substance, the complainants allege in their bill of complaint that they are citizens of Morris County, New Jersey; that the defendants Harrington are citizens of the State of New York, and that the defendants Sol Sayles Company and Sayles, Zahn Company are likewise citizens of said State, both being incorporated under the laws of that State; that the Sol Sayles Company was organized with a capital stock of $100,000, divided into 1,000 shares of the par value of of $100 per share, of which the complainants owned 500 shares, and the defendants Harrington 500 shares; that by an arrangement made between the owners of the stock, the voting power on a majority thereof was given to the defendant John J. Harrington, who directed the management of the affairs of the corporation, dictated its policy, and selected its directors; that on January 26, 1898, the defendant John J. Harrington caused the defendant Sayles, Zahn Company to be organized, for the purpose of taking over the business of the defendant Sol Sayles Company and of one Henry Zahn, and thereupon the property of the Sol Sayles Company and of Zahn were transferred to the Sayles, Zahn Company, which likewise was controlled by the defendant John J. Harrington; that the Sol Sayles Company received in consideration of the transfer of its property, $50,000 of the capital stock of the Sayles, Zahn Company, and subsequently subscribed for $50,000 additional stock (Record, pp. 3 & 4).

It is further alleged that about February 1, 1899, the defendants Harrington, for the purpose of

cheating and defrauding the Sol Sayles Company, and the complainants, of their interest in the assets of the Sayles, Zahn Company, fraudulently caused the Sol Sayles Company to execute and deliver to them, without any consideration whatsoever, its promissory notes aggregating $23,700, which were utterly fictitious, and thereafter, and on October 3, 1902, the defendants Harrington, in furtherance of their fraudulent scheme, caused an action to be instituted and a judgment to be recovered against the Sol Sayles Company, for the amount of the said promissory notes and interest which was alleged to have accrued thereon, the Sol Sayles Company being in utter ignorance of the nature of the action and omitting to interpose any defence thereto (Record, pp. 4 & 5).

This scheme resulted in the recovery of a judgment against the defendant Sol Sayles Company on October 28, 1902, for $27,357.26, in favor of the defendants Harrington, who thereupon caused an execution to be issued to the Sheriff of the County of New York, against the property and assets of the Sol Sayles Company, under which execution the said Sheriff levied on the shares of stock in the Sayles, Zahn Company, and also two bonds of the New Jersey Steamboat Company, which belonged to the Sol Sayles Company, and sold all of the right, title and interest of the Sol Sayles Company in the said certificates of stock and in the said bonds, the said defendants Harrington causing them to be purchased for their own benefit; said shares of stock being then, as the defendants Harrington well knew, and have ever since continued to be, worth upwards of $200,000 (Record, pp. 6 & 7).

It is further alleged that the complainants caused a demand to be made upon the defendants Harrington, that they transfer the said shares of

stock and the said bonds to the Sol Sayles Company, but that they have refused to do so, and have insisted that these shares of stock and bonds are their personal and individual property, and that neither the Sol Sayles Company nor the complainants have any right, title or interest in either the said shares of stock or the said bonds, or any part thereof (Record, p. 7).

The twentieth paragraph of the bill of complaint (p. 7) is as follows:

"The complainants were and each of them was a shareholder of the defendant Sol Sayles Company at the time of the transactions herein complained of. This suit is not a collusive one to confer upon a Court of the United States jurisdiction of a case of which it would not otherwise have cognizance. The complainants are unable to secure any corporate action on the part of the defendant Sol Sayles Company to redress the wrongs hereinbefore set forth, nor are they able to obtain any redress at the hands of the stockholders of the said defendant Sol Sayles Company. The Board of Directors of said corporation is under the absolute control and domination of the defendant John J. Harrington and the said Harrington, by reason of having possession of a majority of the capital stock of the said corporation, likewise controls the action of the stockholders. Although requested for information with regard to the facts hereinbefore set forth, he has refused to give any information with regard thereto, and has declined to redress the wrongs of which complaint is herein made or to give to the complainants any opportunity to lay before the Board of Directors or the stockholders of the defendant Sol Sayles Company the facts herein set forth."

After issue was joined in this suit, and notice was given for the taking of depositions, the defendants moved, at a term of the United States Circuit Court for the Southern District of New York held by Hon. E. Henry Lacombe, Circuit Judge, for a

dismissal of the bill of complaint, on the ground that the said Court lacked the necessary jurisdiction to entertain the suit, and thereupon a decision was rendered dismissing the bill for lack of jurisdiction, and a decree was entered accordingly (Rec., p. 26).

An appeal to this Court was thereupon allowed, and a certificate as to the question of jurisdiction involved in the aforesaid decision was duly made in accordance with the provisions of Section 5, Chapter 517, of the Act of March 3, 1891. The ground of decision stated in said certificate, is as follows:

"That it appeared from the said bill of complaint that there was no such diversity of citizenship between the parties complainant and defendant as would confer jurisdiction upon the United States Circuit Court for the Southern District of New York in this cause within the meaning of the United States Revised Statutes, and that in arranging the parties to this cause relatively to the controversy the Sol Sayles Company must be grouped on the side of the complainants, with the result that citizens of the same State would thus be parties on both sides of the litigation and thus deprive this Court of jurisdiction" (Rec., p. 36).

The appellants' assignments of error are as follows:

First.—The Court erred in dismissing the said cause and in entering a decree in favor of the defendants dismissing the cause.

Second.—The Court erred in holding that it had no jurisdiction of this cause on the ground that there was no such diversity of citizenship of the parties thereto as is required by the provisions of the United States Revised Statutes.

Third.—The Court erred in holding that it had

no jurisdiction of this cause, for the reason that in arranging the parties relatively to the controversy the Sol Sayles Company was to be grouped on the side of the complainants, with the result of bringing citizens of the same State on both sides of the litigation and thus depriving this Court of jurisdiction (Record, p. 38).

The two propositions upon which the appellees have relied to defeat the jurisdiction of the Federal Court in this cause, are as follows:

(1) That this suit cannot be maintained in the Federal Courts, because there is no such diversity of citizenship between the complainants and the defendants as is required under the Federal Statutes, it being argued that the complainants, who sue as stockholders of the Sol Sayles Company, are, by an irrebuttable presumption, deemed citizens of the State of New York, under the laws of which State the Sol Sayles Company was organized, and of which State, all of the other defendants are citizens.

(2) That this suit, being a derivative action, in which the complainants are suing solely for the benefit of the Sol Sayles Company, a New York corporation, that corporation, although in form a defendant, is in legal effect on the same side of the controversy as the complainants, and since the Sol Sayles Company is a citizen of the same State as the remaining defendants, the Federal Courts have no jurisdiction, inasmuch as the suit does not involve a controversy between citizens of different States.

The appellants contend, that although there is apparent logic in support of these propositions, the decisions of this Court, so far as they touch the subject, do not sustain them.

ARGUMENT.

I.

There is a diversity of citizenship between the complainants and the defendants, the former being citizens of New Jersey and the latter of New York.

It is true that the complainants are stockholders of the Sol Sayles Company, that their sole right to seek redress from the wrongs complained of is a derivative one, based on the allegations that a fraud has been perpetrated on the Sol Sayles Company, and that unless relief could be afforded to that corporation, had it instituted this action, the complainants would have no standing in Court.

It is none the less true, that the complainants, as individuals, are in fact citizens of New Jersey, and not of New York, the State under whose laws the corporation of which they are stockholders was organized.

The defendants contend, that whatever the fact may be, the complainants are estopped or debarred from asserting such fact by reason of the decisions of this Court in *Louisville &c. R. R.* v. *Letson, 2 How. U. S., 497, 558; Marshall* vs. *Baltimore and Ohio R. R. Co., 16 How., 325; St. Louis & San Francisco Railway Co.* v. *James, 161 U. S., 545; Barrow Steamship Co.* v. *Kane, 170 U. S., 100; Southern Railway Co.* v. *Allison, 190 U. S., 326,* and many other cases in which it has been held, that for the purpose of conferring jurisdiction upon the Federal Courts over a corporation, there is a conclusive presumption of law that all of the stockholders of such corporation are citizens of

the State in which the corporation was organized, and that this presumption is irrebuttable, and cannot be defeated by allegations or evidence to the contrary.

It is therefore argued, that if all of the stockholders of a corporation, are to be absolutely and conclusively presumed, as a matter of law, to be citizens of the State in which the corporation was organized, in order to confer jurisdiction over the corporation, that presumption cannot, in the same suit, be disregarded, in order to enable a stockholder of such corporation, to maintain a derivative action in the right of that corporation against it, and other defendants.

On its face, this would seem to be good reasoning; but it is based entirely on a legal fiction, which has been indulged for the purpose of enabling the Federal Courts to exercise jurisdiction over corporations. Legal fictions, however, are not always carried out to their logical conclusion, and this Court has entertained jurisdiction in numerous instances, where precisely the same state of facts existed, as in the present case. Among the more important precedents are the following:

Dodge v. *Woolsey, 18 How., 331.*
Hawes v. *Oakland 104 U. S., 450.*
Quincy v. *Steel, 120 U. S., 241.*
Pollock v. *Farmers L. & T. Co., 157 U. S., 429.*
Cotting v. *Kansas City Stock Yard Co., 183 U. S., 79.*

Moreover, if this Court had considered the proposition now urged as sound, it would not have been necessary for it to promulgate the 94th Rule in Equity, which was done on January 23, 1882, at the time of the rendition of the decision in

Hawes v. *Oakland* (*supra*). That rule is as follows:

"Every bill brought by one or more stockholders in a corporation against the corporation and other parties, founded on rights which may properly be asserted by the corporation, must be verified by oath, and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law, and that the suit is not a collusive one to confer on a Court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders, and the causes of his failure to obtain such action."

This rule apparently recognizes the jurisdiction of the Federal Courts, over suits by stockholders, suing in the right of the corporation, so long as there is no collusion for the purpose of giving jurisdiction to the Federal Courts.

It was argued in the Court below, that in *Dodge* v. *Woolsey*, *Pollock* v. *Farmers Loan & Trust Company* and *Cotting* v. *Kansas City Stock Yard Company* (*supra*), Federal questions were involved which would have conferred jurisdiction on the Federal Courts, irrespective of diversity of citizenship, but it will be observed that in these cases jurisdiction was claimed on the ground of diversity of citizenship.

It is likewise true, that in *Hawes* v. *Oakland* and *Quincy* v. *Steel* (*supra*), relief was refused to the complainants, but such refusal was not based on the ground now urged to defeat Federal jurisdiction.

Attention is further called to the recent decision in *Utah-Nevada Co.* vs. *De Lamar*, 133 *Fed. Rep.*, 113.

II.

Even though the complainants are seeking to maintain this action in the right of the Sol Sayles Company, in view of the trend of authority that fact is not entitled to weight as against the circumstances that the Sol Sayles Company is in fact a defendant.

It is doubtless true, as was contended in the Court below, that in arranging the parties relatively to the controversy between them the mere form of pleading is frequently set aside and the parties are placed on different sides of the matter in dispute according to the facts, and when upon such an arrangement it appears that citizens of the same State appear on both sides of the controversy, it is not within the jurisdiction of the Federal Courts.

It is sought to apply this rule to the present case. It was equally applicable to the cases considered under the last point, but it was not done.

This was treated as an important consideration in the Circuit Court of Appeals for the Second Circuit, in *De Neufville* v. *New York and Northern Railway Company, 81 Fed. Rep., 10, 13,* where the Court said of a similar case:

"It is the property of the corporation which has been taken, and it is the corporation which is entitled to its return, or to an accounting for its proceeds. When the corporation succeeds, complainant's share of stock will be worth more; and to that extent he has an interest in the result, which the Courts have recognized to the extent of allowing a dissatisfied stockholder, upon a sufficient showing of unsuccessful efforts to induce action by the officers of the corporation, himself

to bring the cause of action before the Court for consideration. But, in whatever form or under whatever name it is presented, it is the cause of action of the corporation, and of the corporation alone. The real controversy is between the corporation, whose officers refuse to assert its rights, and the alleged conspirators, who have deprived it of its property. If the wholesome rule approved by the Supreme Court in numerous decisions were followed, and the parties arranged, not as they stand in the title, but according to their interest in the controversy, we would have the New York and Northern Railway Company classified as a plaintiff, and the diversity of citizenship necessary to confer jurisdiction would no longer exist. If the Circuit Courts were entirely free to enforce the provisions of the fifth section of the Act of 1875 to every case where it logically applies, they would, no doubt, be able to relieve their dockets as was suggested in Hawes *v.* Oakland, 104 U. S., 450, of many cases which have no proper place there; but the decisions in Dodge *v.* Woolsey, 18 How., 331; Hawes *v.* Oakland (*supra*), and Quincy v. Steel, 120 U. S., 241, and the 94th Rule in Equity, seem to preclude a strict application in cases such as the one at bar, of the rule that parties may be rearranged according to their interest in the controversy."

III.

It is submitted that the decree appealed from should be reversed, with costs.

CHARLES A. HESS,
Appellants' Counsel.